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**Investment Credit Provisions
of the Revenue Act of 1962
Affecting Farmer Cooperatives**

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U. S. Department of Agriculture

FARMER COOPERATIVE SERVICE
U. S. DEPARTMENT OF AGRICULTURE
WASHINGTON, D. C. 20250

Joseph G. Knapp, Administrator

The Farmer Cooperative Service conducts research studies and service activities of assistance to farmers in connection with cooperatives engaged in marketing farm products, purchasing farm supplies, and supplying business services. The work of the Service relates to problems of management, organization, policies, financing, merchandising, product quality, costs, efficiency, and membership.

The Service publishes the results of such studies; confers and advises with officials of farmer cooperatives; and works with educational agencies, cooperatives, and others in the dissemination of information relating to cooperative principles and practices.

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INVESTMENT CREDIT PROVISIONS OF THE REVENUE ACT OF 1962
AFFECTING FARMER COOPERATIVES

by
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The investment credit provision (Section 38) of the Internal Revenue Code of 1962 provided financial incentives to corporations to modernize or expand facilities.

To accomplish this, the 1962 Act provided for a credit to be offset directly against the income tax liability. But the 1962 Act, under the so-called "Long Amendment," also reduced the depreciation base of eligible property, thus somewhat limiting the inducement provided by the tax credit.

The Long Amendment, however, has been repealed under provisions of the Revenue Act of 1964. Therefore, the depreciation base for eligible property placed in service after December 31, 1963, will not be reduced by the amount of the credit.

As to property placed in service before January 1, 1964, a taxpayer may increase its depreciation base by the amount of credit taken in 1962 and 1963 and depreciate it in the future. The restored base must be reduced, however, by any previous restoration made under applicable provisions of the Code.

The purpose of this publication is: (1) To summarize the more important investment credit provisions of the Revenue Act of 1962, as amended by the Revenue Act of 1964, and (2) to examine the applicability of these provisions and their impact on the operations of agricultural cooperatives.

INVESTMENT CREDIT PROVISIONS

The salient investment credit provisions are summarized in the paragraphs that follow.

1. Rate

The credit generally is an amount equal to 7 percent of the cost of a "qualified investment" in "Section 38" property. Property with an estimated depreciable life of 8 years or more is eligible for the full 7 percent credit.

If the estimated useful life is 6 years or more but less than 8 years, it is eligible for credit of 7 percent of two-thirds of the cost of such assets. If the estimated depreciable life is 4 years or more, but less than 6 years, the credit is computed at 7 percent of one-third of the cost of the 4-year assets.

2. Method of Depreciation Allowable

If a taxpayer is using a method of depreciation, such as the unit of production method, which does not measure the life of the property in terms of years he must estimate such life in years in order to compute his qualified investment.

3. Qualified Property Defined

The following general rules apply in determining a "qualified investment."

A. 'Section 38' property must be depreciable property and have a useful life of 4 years or more. The property may be new or used, and in order to be eligible for the credit must be purchased or otherwise acquired--and used--after December 31, 1961.

B. Eligibility of used property for the credit is limited to the extent of \$50,000 a year in purchases.

C. Types of property that qualify for the credit include tangible personal property (including items that by local law may be classified as fixtures), and real property (other than building or structural components) that is an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, or public utility services. Escalators and elevators installed or modernized after June 30, 1963, will be eligible for the tax credit for the first time.

4. Property Ineligible for Credit

Types of property that do not qualify for the credit are properties that are:

- a. Predominantly used to furnish lodging.
- b. Used by a tax exempt organization.^{1/}
- c. Used by governmental units.
- d. Used predominantly outside the United States.
- e. Livestock.

5. Twenty-Five Percent Limitation

The amount of the credit may not exceed the total tax liability. When the tax liability is more than \$25,000, the credit may not exceed \$25,000 plus 25 percent of the liability in excess of that amount.

^{1/} Property used by an exempt organization other than farmer cooperatives can qualify only as it is used predominantly in an unrelated trade or business which is taxable.

6. Carryback and Carryover Limitations

It is entirely possible that part of an investment credit cannot be used in a current taxable year because of the \$25,000 and 25 percent limitation.

The law provides that the excess portion that cannot be used in a current taxable year may be carried back for use to each of the 3 preceding years (beginning after December 31, 1961), and carried forward to any of the following 5 taxable years. In order of priority, however, the current year's credit must first be used, after which the unused credit from a carryback or carryover year will be used.

7. Adjustments to Credit and Recapture of Taxes

The investment credit may be reduced if:

- a. The assets are disposed of before the end of their estimated useful lives.
- b. The assets cease to be "qualified" property.

In the event an investment credit is reduced, Federal income taxes are "recaptured" by increasing the tax for the current year by the amount the credit should have been reduced in the prior year. This makes it unnecessary to recompute taxes in the prior years.

IMPACT ON COOPERATIVES

The applicability of the investment credit with respect to cooperatives is limited. The credit can be utilized only if there is taxable income. Moreover, both the qualified investment and the \$25,000 credit limitation cited in paragraph 5 must be reduced by the ratio of taxable income (the numerator) to a denominator that includes taxable income plus special reductions applied against taxable income, such as qualified patronage refunds and redemptions of nonqualified patronage refunds.

Exempt cooperatives would have little taxable income. In addition, the fraction used by an exempt cooperative would be relatively smaller than the fraction used by a nonexempt cooperative because the denominator would also include dividends on capital stock and patronage refunds derived from non-patronage sources which are allocated to patrons on the basis of their patronage.

Thus a nonexempt cooperative could use this credit to greater advantage than an exempt cooperative.

Examples follow on the effect of the limitations cited.

Nonexempt Cooperative

Assume the total cost of "Section 38" property of a nonexempt cooperative is \$400,000 and its taxable income is \$50,000 after taking into account \$950,000 of "qualified patronage dividends" under Subchapter T of the Internal Revenue Code of 1954, as amended. Thus its net margins before the patronage refund exclusion amount to \$1,000,000.

The cooperative's qualified investment would be computed as follows:

$$\$400,000 \times \frac{\$50,000 \text{ (taxable income)}}{\$50,000 \text{ (taxable income)} + \$950,000 \text{ (qualified allocations)}}, \text{ or}$$

$$\$400,000 \times \frac{\$50,000}{\$1,000,000}, \text{ or}$$

$$\$400,000 \times \frac{1}{20}, \text{ or } \underline{\underline{\$20,000}}$$

Similarly, the \$25,000 credit offset against its income tax would be reduced as indicated by the following computation:

$$\$25,000 \times \frac{1}{20}, \text{ or } \$1,250, \text{ and the 25 percent limitation would apply, in this}$$

example, to the income tax credit over \$1,250.

Assuming that the property purchased has an estimated depreciable life of 10 years, a full 7 percent credit, adjusted because of the special rule applying to cooperatives, is permitted.

In this example, the offsetting credit against the income tax would amount to 7 percent of \$20,000, the amount of qualified investment, or \$1,400. Since the useable credit in our example cannot exceed \$1,250 plus 25 percent of the amount in excess of \$1,250, the total credit useable currently would amount to \$1,237.50. $\frac{\$1,250 \text{ plus 25 percent of } \$150}{(\$1,400 - \$1,250)}$ The unused excess portion (75 percent of \$150) can be carried back or carried forward as described in paragraph 6.

Exempt Cooperative

Assume the total cost of "Section 38" property of an exempt cooperative is \$400,000 and its taxable income is \$10,000 (derived from business done with non-consenting nonmember patrons) after taking into account \$950,000 of "qualified patronage refunds" under Subchapter T of the Internal Revenue Code of 1954, as amended, a deduction of \$30,000 of dividends on capital stock, and a deduction of \$10,000 of patronage refunds derived from business done for the United States Government.

Its net margins before the exclusions and deductions amount to \$1,000,000. The association's qualified investment would be computed as follows:

$$\$400,000 \times \frac{\$10,000 \text{ (taxable income)}}{\$10,000 \text{ (taxable income)} + \$30,000 \text{ (capital stock dividends)} + \$10,000 \text{ (nonpatronage refunds)} + \$950,000 \text{ (qualified allocations)}, \text{ or,}$$

$$\$400,000 \times \frac{\$10,000}{\$1,000,000}, \text{ or}$$

$$\$400,000 \times \frac{1}{100}, \text{ or } \underline{\underline{\$4,000}}$$

Similarly, the \$25,000 credit offset against the income tax would be reduced as indicated by the following computation:

$$\$25,000 \times \frac{1}{100}, \text{ or } \$250, \text{ and the 25 percent limitation would apply, in this}$$

example, to the tax credit in excess of \$250.

Again assuming that the property purchased has an estimated depreciable life of 10 years, a full 7 percent credit against the tax liability, adjusted because of the special rule applying to cooperatives, is permitted.

In this example the credit would amount to 7 percent of \$4,000, or \$280. Since our example again illustrates a credit in excess of the computed \$250 limitation, the current useable credit amounts to \$250 plus 25 percent of the excess over the \$250 limitation, or a total of \$257.50. The unused excess portion (75 percent of \$30), or \$22.50, can be carried back or carried forward as described in paragraph 6.

